The Pension Benefit Guaranty Corporation assumed $1.8 billion in assets from failed employer and multiemployer pension plans in fiscal year 2010, according to its Web site. Further, public sector pension funds in the United States may be underfunded in aggregate by as much as $3 trillion. The enormity of the challenges faced by pension funds in the wake of the financial crisis has prompted asset owners to revisit the alignment of their activities, practices and policies with their pension plan investment objectives.

The emerging trends in global corporate governance support the momentum toward active stewardship of plan assets on behalf of pensioners. The key themes emerging in corporate governance follow a consistent pattern toward:

- Adopting global standards and best practices in governance
- Increasing communication and dialogue between investors and companies
- Actively monitoring and reporting on stewardship activities
- Reinforcing proxy voting as a fiduciary obligation.

**Regulation Leads the Way**

Reform movements often take many forms, from grassroots ideas to significant events that strike a chord with a broad constituency. In 2010, governance reform in the U.S. came directly from Capitol Hill. Similarly, regulatory bodies in other global markets took actions on behalf of investors.

**The Dodd-Frank Act**

The 2010 passage of the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act was the most significant overhaul of the U.S. financial system since the Great Depression. The Dodd-Frank provisions:

- Give shareholders the right to a nonbinding vote on executive compensation (say on pay) and executive severance payouts (golden parachutes)
- Call for enhanced oversight of compensation practices in the financial industry
- Demand independent compensation committees as an exchange listing standard
- Require the clawback of executive compensation tied to inaccurate financial statements
- Obligate corporate disclosure of pay disparity between a company’s employees and that of its CEO.

**Securities and Exchange Commission Actions**

The U.S. Securities and Exchange Commission (SEC) has also taken regulatory actions to enhance investor protections and facilitate greater corporate transparency and accountability. Last year, SEC prohibited brokers from voting uninstructed ballots in board elections, a practice that formerly favored management recommendations. SEC also mandated new proxy disclosures on risk oversight, board leadership, diversity and director qualifications. And the Dodd-Frank Act requires the commission to establish an Investor Advisory Committee to advise it on investor perspectives and matters of concern to investors in the securities markets.

**The European Union Shareholder Rights Directive**

The European Union (E.U.) Shareholder Rights Directive, passed by the European Parliament and Council in July 2007, was intended to harmonize shareholder rights and practices among E.U. member states, promote the exercise...
of shareholder rights and enhance the proxy voting process.

Key provisions of the E.U. directive include:

- The introduction of a record date no more than 30 days prior to general shareholder meetings
- Timely and accessible delivery of information to shareholders, such as minimum notice periods for shareholder meetings and Internet publication of shareholder meeting materials and voting results
- Investor right to pose questions at shareholder meetings
- Ability to participate electronically at shareholder meetings
- Abolition of excessive formal appointment procedures and the dismantlement of restrictions around the ability to act by proxy.

The U.K. Stewardship Code

Following a review of the combined corporate governance code and the governance of the banking industry in the United Kingdom, the Financial Reporting Council (FRC), overseer of corporate governance and reporting in the U.K., recommended the adoption of an investor stewardship code. The stewardship code requires greater monitoring of and engagement with companies by investors individually or collectively, and calls for investor disclosure of proxy votes and the policies that guide them.

The U.N. Principles for Responsible Investment

The United Nations Principles for Responsible
Investment, which are forged on the premise that environmental, social and governance considerations can be material to investment performance, are designed to encourage informed, engaged and active ownership. The goal of these principles is consistent with the other codes and regulatory actions previously mentioned: to mitigate investment risk and enhance long-term shareholder returns. More than 850 signatories worldwide representing over $22 trillion in assets have subscribed to the principles and are influencing governance practices globally.

**Impacts for Investors**

Greater active ownership by investors is anticipated to fuel the level of engagement with issuers. Along with greater scrutiny of executive compensation, additional transparency in corporate disclosures will benefit the engagement process and increase the robustness for evaluating governance practices.

**Engage With Issuers**

Pension funds have obligations to pay retirement benefits for decades into the future. Ownership practices, such as engagement, can help ensure sustained investment performance over a long-term horizon. The regulatory backdrop clearly advocates active ownership and greater constructive dialogue between investors and companies. Whether by reaching out directly to corporations within their portfolios or engaging with entities like investment managers that contact the companies, institutional investors are being held to a higher standard of engagement.

Developments that have influenced investor-issuer interactions and the manner in which corporations are governed include:

- Significant growth in institutional investor ownership of U.S. companies over the past two decades
- An increase in the international diversity of the shareholder base at European firms and a decrease in barriers to cross-border investing
- The spate of regulatory, legislative and voluntary changes promoting shareholder rights inspired by the financial crisis
- Increasing complexity of voting topics fueled by provision of additional information that investors can now act upon
- The availability of more versatile instruments in the shareholder arsenal with which to hold companies accountable, including majority vote standards in director elections and “say on pay.”

According to a survey on engagement between issuers and investors conducted by Institutional Shareholder Services Inc. (ISS) on behalf of the Investor Responsibility Research Center (IRRC) Institute, investors cite impediments to engagement activity such as time and staffing constraints, regulatory concerns by issuers and differing investor viewpoints on corporate governance practices.

**Scrutinize Executive Compensation**

Corporate compensation practices continue to draw considerable media attention and public focus. Considered a litmus test for board independence, executive compensation practices are highly scrutinized by investors that are placing greater emphasis on the need for an alignment between pay and performance. Disconnects between pay and performance often serve as an indicator of other practices at a firm that may expose investors to unnecessary risk.

**Tax gross-ups** (when an employer reimburses the taxes paid on some portion of an employee’s income, including income that is imputed for tax purposes) for executives are one of the most common items on the investor reform punch list. More than 200 U.S. companies have eliminated excise tax gross-ups in current or future executive severance agreements, according to data compiled by ISS. A number of U.S. companies have also eliminated the provision of executive perquisites such as personal use of corporate aircraft, housing allowances and automobile leases, and the tax gross-ups that may be associated with such perks.

In the U.S., Canada and, increasingly, across Europe, the ability of shareholders to provide a “thumbs up” or “thumbs down” advisory vote on executive pay practices is taking a strong foothold. Legislative action to mandate “say on pay” votes has extended the up/down pay vote to all companies in the U.S. In addition, U.S. investors will get to choose the frequency of say on pay votes for the first time as part of the...
Dodd-Frank Act provisions. In 2011, shareholders will get to voice their preference for the frequency of say on pay—every one, two or three years. Thereafter, shareholders will get to vote on the frequency of say on pay every six years.

Under the Dodd-Frank legislation, investors will also get to vote on severance payments to executives (golden parachutes) whenever they are asked to approve a merger and acquisition transaction or a disposition of assets. The golden parachute vote disclosures will include agreements that a firm has with any officer concerning any type of compensation related to the transaction, the aggregate compensation that may be paid or is payable to an executive officer, and the conditions under which such compensation is payable.

Understand New Disclosures

The extent and quality of corporate disclosures is critical to the evolution of governance and voting practices worldwide. High-quality and consistent disclosures enable asset owners to make more informed decisions that comport with their investment philosophies and policies.

Corporate disclosures on a number of fronts have shown dramatic improvement, especially in some European markets, following regulatory or legislative enactments. Implementation of the E.U. Shareholder Rights Directive translates to availability of more timely and accessible disclosures. Some highlights of the impacts of the E.U. directive and other country specific legal directives include:

- Better shareholder meeting Internet disclosures
- Expanded liabilities for companies for environmental damages
- Investor disclosures of the environmental, social and governance criteria used in investment decision making, including proxy voting
- Implementation of clawback provisions for compensation disbursed on the basis of false or misleading information.

In the U.S., new SEC disclosure requirements will shed more light on a number of topics including director qualifications, rationale for combined CEO/chair positions, risk oversight practices and how they tie to executive compensation, and considerations around board diversity.

Greater emphasis on transparency of environmental and social criteria can be seen in a number of markets worldwide and in the basic tenets of the U.N. Principles for Responsible Investment. France, Germany, the U.K. and Norway have called for greater gender diversity in corporate boardrooms. In France, regulations have reinforced the need for corporate social responsibility by obligating large companies with 500 or more employees to publish a report that discloses environmental issues related to their operations such as carbon emissions.

New disclosures promulgated by the Brazilian Securities Regulator in late 2009 dramatically improved the level and timeliness of disclosure in Brazil in 2010. The disclosure requirements mandated companies to provide greater information on board members, including biographical and independence information, as well as additional transparency around the minimum, average and maximum compensation levels of board members and executives.

While listed companies in China exhibited improvements in the timely publication of annual report and shareholder meeting materials in 2010, the quality of China’s corporate disclosure practices have historically been lackluster. This may change. The China Securities Regulatory Commission imposed stricter disclosure standards for M&A transactions, investment proposals and financing requests. In Japan, companies are now required to disclose the pay of directors whose aggregate compensation exceeds JPY 100 million ($1.2 million). Additionally, disclosure of compensation policies is now mandated for all Japanese companies, regardless of pay magnitude.

Alongside this rise in the quality of disclosures is an increase in the meaningfulness of shareholder voting. New disclosure requirements will allow shareholders to vote on severance payments to executives, which may be contingent on merger and acquisition transactions or asset disposals.

takeaways >>

- In 2010, the Securities and Exchange Commission and the Dodd-Frank Act led the way in U.S. corporate governance reform; regulatory bodies in other global markets also acted on behalf of investors.
- It’s expected that investors will take a more active role, including scrutinizing executive compensation more closely, as corporations become more transparent in their disclosures.
- The investor voting process in nearly all markets is convoluted. As these processes are reformed, investor votes will have more meaning.
of corporate disclosures worldwide, there is increasing momentum around investor disclosure of proxy voting activity. In the U.S., SEC has proposed rules for the reporting of proxy votes on executive compensation and other matters by a broad base of institutional investment managers. In Japan, the disclosure of vote results detailing the percentages of shareholder support and opposition is now required. The U.K. Financial Reporting Council’s investor Stewardship Code also calls for disclosure on investment stewardship, including proxy voting activity.

**Monitor the Mechanics**

As investors have been increasingly empowered to exercise their rights of ownership, attention is also being paid to the mechanics of the voting process itself, which in almost all markets is a convoluted process with multiple intermediaries and complex data flows. Effective corporate governance depends on robust and accurate voting processes that give meaning to investor votes and that assure voting interests reflect true economic interest. As the E.U. Shareholder Rights Directive is implemented, European markets are phasing out the traditional practice of share blocking. Share blocking is a practice in which investors that wish to exercise their voting rights are precluded from trading securities a few days prior to a shareholder meeting, which typically inhibits the ability to vote shares for fear of failed trades. Abolition of share blocking is widely expected to translate to increased shareholder activism next year now that investors will increasingly have the ability to freely exercise their voting rights.

There has also been an increasing focus on how practices such as share lending and hedging transactions raise the potential for economic interest and voting rights to diverge. Share lending is a practice in which securities are transferred from one party to another for a fee and a promise by the borrower to return equivalent securities. These lending transactions are typically used to facilitate short selling, but they also effectively transfer full ownership rights, including voting rights, to the borrower. Investors have also increasingly used derivatives in order to hedge their economic exposure to stocks, but their voting rights are typically unaffected in these transactions. As such, these practices have come under scrutiny for their potential to separate investors’ economic interests from their ownership and voting rights.

In July 2010, SEC published a “Proxy Plumbing” Concept Release that sought to examine the accuracy, transparency and efficacy of the proxy voting process in the U.S. with an aim to modernize the proxy voting infrastructure. SEC also set out to evaluate the relationship between voting power and economic interest. Vote confirmation was among the topics SEC solicited public comment on in its Concept Release. The U.S. proxy system lacks a uniform, transparent and robust vote confirmation process whereby investors can confirm the status of a proxy ballot from the time it is issued to the time shares are voted at a shareholder meeting. An effective end-to-end vote confirmation process is needed to facilitate the proper execution of shareholders’ voting rights.

**Conclusion**

The regulatory regimes worldwide have clearly set the stage for encouragement of more active, informed ownership. Investors need to be aware of the challenges and the opportunities they present in order to navigate a landscape with new practices and new information. If successful, asset owners and managers will serve their underlying beneficiaries in a manner that comports with their fiduciary obligations.

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